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Date:

August 06, 2009

Legend:

Taxpayer =

Trust =

State =

Board =

Committee =

Dear :

This is in reply to your letter dated February 26, 2009, and subsequent correspondence, in which you request various rulings on behalf of Taxpayer with respect to Trust and benefits provided by Trust.

FACTS

Taxpayer is a governmental entity, created by State statute. Taxpayer provides health and welfare benefits for its active and retired employees, their spouses and dependents.

Taxpayer is governed by a seven member Board. One member is a state official and six members are selected by the governor of State.

Trust was created by Taxpayer to provide a vehicle for accumulating amounts needed to pay for retiree benefits. Taxpayer is the sole participating employer in Trust. Trust income is derived from Taxpayer contributions, employee contributions and investment income. Trust income is used exclusively to provide health and life insurance benefits to its retirees and their spouses and dependents and to pay for the cost of administering Trust. Taxpayer represents that the liabilities of the Trust with regard to each benefit provided are accounted for separately. No private interests participate in or benefit from the operation of Trust other than as providers of goods and services.

Trust's initial trustee is the seven member retiree benefits Trust Committee of Taxpayer. Committee receives contributions, distributes benefits and invests Trust assets. Any trustee can be removed and replaced by Board. Successor trustees are selected as follows: one trustee is selected by Board; three trustees are officers of Taxpayer, all of whom serve at the pleasure of Board; one trustee is selected by the CEO of Taxpayer. Taxpayer's CEO also serves at the pleasure of Board.

Board has the right to amend Trust at any time without the consent of the trustees. Taxpayer also has the right to terminate Trust. Upon termination, assets of Trust are used exclusively to pay the administrative expenses of Trust and to provide for retiree benefits. Board has amended the Trust agreement to clarify that in no case will any assets in Trust be distributed to an entity that is not a state, a political subdivision of a state, or an entity the income of which is excluded from gross income under section 115 of the Internal Revenue Code (the Code).

The health benefits are provided through insured plans. There is no salary-reduction election with respect to the retiree health benefit coverage. In addition, Taxpayer represents that there is no cash-out of any unused amounts and no conversion of the value or sick or vacation days to retiree health.

Trust provides for payment of premiums for \$5,000 of basic group-term life insurance for certain eligible retirees. Taxpayer pays the full cost of the basic coverage. Eligible retirees also have the option to purchase additional life insurance coverage. The full cost of the optional insurance selected by the retiree is paid for by the retiree on an after-tax basis. Taxpayer does not subsidize any of the cost of the optional insurance. All rates charged for the optional insurance are age-based and all are below the Table I rates found in section 1.79-3(d) of the Income Tax Regulations. The group-term life insurance plan does not discriminate in favor of key employees under the rules of section 79(d) of the Code.

Both the basic and the optional insurance coverage are purchased through the same insurance company. Taxpayer represents that the premium rates for the optional

insurance are determined separately from and independently of the premium rates for the basic life insurance. The finances of the optional and basic insurance plans are accounted for separately and independently. The optional insurance does not subsidize the basic insurance, nor does the basic insurance subsidize the optional insurance.

Trust may be terminated only if Taxpayer ceases contributions to Trust and all assets of Trust are distributed in accordance with the purposes of Trust Agreement.

LAW AND ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under section 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct. In addition, pursuant to section 6012(a)(2) and the underlying regulations, the investment fund, being classified as a corporation that is subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) was excludable from gross income under section 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Trust provides medical and life insurance benefits to retired employees of Taxpayer, their spouses and dependents. Providing medical and life insurance benefits to former public employees constitutes the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performs an essential governmental function within the meaning of section 115(1) of the Code.

The income of Trust accrues to Taxpayer, its sole participating employer. No private interests participate in or benefit from the operation of Trust other than as providers of goods or services. The Trust's dedication of its corpus or income exclusively for the benefit of the retirees, their spouses and dependents, satisfies an obligation Taxpayer has assumed or been assigned with respect to providing benefits to its employees. The benefit to Taxpayer's participating employees, their spouses and dependents, is incidental to the public benefit. See Rev. Rul. 90-74.

Section 61(a)(1) of the Code and section 1.61-21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in subtitle A of the Code, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

However, section 106(a) of the Code provides that gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.106-1(a) of the regulations provides that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in section 105(e)) which provides accident and health benefits directly or through insurance to one or more of his employees. However, if the insurance policy, trust or fund provides other benefits in addition to accident or health, section 106 applies only to the portion of the contributions allocable to accident or health benefits.

Coverage provided under an accident and health plan to former employees and their spouses and dependents is excludable from gross income under section 106. See Rev. Rul. 62-199, 1962-2 C.B. 32; Rev. Rul. 82-196, 1982-2 C.B. 53. But, employer-provided coverage under an accident or health plan for personal injuries or sickness incurred by individuals other than the employee, his or her spouse, or his or her dependents (as defined in section 152), is not excludable from the employee's gross income under section 106.

The taxation of employer-provided group-term insurance on the life of an employee, including a retiree, is governed by section 79 of the Code. Under section 79(e), the term "employee" includes a retiree. If a group-term life insurance plan meets the non-discrimination requirements of section 79(d), \$50,000 of such coverage is excludable from the employee's income. For coverage above \$50,000, section 79 requires the employee to include in income an amount equal to the cost of life insurance provided under a policy carried directly or indirectly by his or her employer (less any amounts paid by the employee toward the purchase of such insurance). Section 79(c) requires

the "cost" of the insurance to be computed by using the uniform premiums prescribed in Table I of the section 79 regulations.

Section 1.79-1(a) of the regulations sets out the conditions that must be met before a policy of life insurance will be considered group-term life insurance for purposes of section 79. Section 1.79-1(a)(3) of the regulations requires that the life insurance be "provided under a policy carried directly or indirectly by the employer."

The meaning of the term "policy," for purposes of section 79 includes two or more obligations of an insurer (or its affiliates) that are sold in conjunction. Section 1.79-0 of the regulations. Obligations that are offered or available to members of a group of employees are sold in conjunction if they are offered or available because of the employment relationship. These obligations of the same insurer are aggregated despite actuarial sufficiency of the premiums charged for each obligation, and even if the obligations are contained in separate documents. The regulations, however, allow an employer to elect to treat two or more obligations, each of which provides no permanent benefits, as separate policies if the premiums are properly allocated among such policies.

Thus, an employer may have more than one policy. However, each policy must be tested separately to determine if it is carried directly or indirectly by the employer. If a policy is not carried directly or indirectly by the employer, no income will be imputed to an employee under section 79 on account of the insurance provided under that policy.

A policy of life insurance is "carried directly or indirectly by the employer" if:

- (a) The employer pays any part of the cost of the life insurance directly or through another person; or
- (b) The employer or two or more employers arrange for payment of the cost of the life insurance by their employees and charge at least one employee less than the cost of his or her insurance, as determined under Table I, and at least one other employee more than the cost of his or her insurance, determined in the same way.

Applying the above rules to the group term life insurance on the lives of the eligible retirees of Taxpayer, both the basic and the optional insurance are available to the retirees because of an employment relationship. In addition, both the basic and the optional insurance are purchased from the same insurer. Therefore, the obligations contained in the basic and the optional coverage will be treated as a single "policy" for purposes of section 79, unless the requirements have been met to elect to treat such obligations as separate policies. Because neither the basic nor the optional coverage contains permanent benefits, the only requirement for electing separate treatment is that the premiums be properly allocated between the basic and the optional coverages.

Based on the information submitted and representations made, we conclude as follows:

- (1) The income of Trust is derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of section 115(1). Accordingly, Trust's income is excludable from gross income under section 115(1) of the Code.
- (2) Contributions paid to Trust which are used exclusively to pay for the accident or health coverage of retired employees, their eligible spouses and dependents as defined in section 152 (determined without regard to sections 152(b)(1), (b)(2) and (d)(1)(B) of the Code) are excludable from the gross income of retirees and their eligible spouses and dependents under section 106. However, to the extent individuals are covered under Trust who do not qualify as a spouse or as a dependent under Federal law, the Trust will, in accordance with applicable tax law, include in the gross income of related employees the fair market value of the coverage for the nonspouse or nondependent.
- (3) The insurance premiums are properly allocated between the basic coverage and optional coverage so that an election can be made to treat the basic and the optional coverage as separate policies for purposes of section 79. Because Taxpayer pays the cost of the basic insurance coverage, the basic coverage is within the definition of "carried directly or indirectly by the employer." However, the optional coverage is not carried directly or indirectly by the employer because Taxpayer neither pays any part of the cost of the optional insurance nor charges employees rates that "straddle" the Table I rates. Because the \$5,000 of basic life insurance coverage is the only coverage provided directly or indirectly by Taxpayer, no amounts are includible in a retiree's gross income with respect to the group-term life insurance provided through Trust.

The ruling assumes that a retiree is not also provided group-term life insurance through another employer, in which case the retiree is required to aggregate the \$5,000 basic coverage provided by Taxpayer with the group-term life insurance coverage provided through the policy or policies carried directly or indirectly by the other employer or employers.

No opinion is expressed on the classification of Trust as a trust or corporation for Federal tax purposes. Further, no opinion is expressed concerning the Federal tax consequences of Plan or Trust under any other provision of the Code other than those specifically stated herein.

This ruling is directed only to the Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representative.

Sincerely,

Harry Beker, Chief
Health and Welfare Branch
Office of Associate Chief Counsel/Division
Counsel (Tax Exempt and Government Entities)